No. 12,144

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HOFFMAN RADIO CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONER.

With Appendix.

Petition to Review a Decision of the Tax Court of the United States

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Opinion Below.

The only opinion in this case is the Memorandum Findings of Fact and Opinion of the Tax Court of the United States, Docket No. 11683, entered June 29, 1948 [R. 21-46], which is not officially reported.

Jurisdiction.

This proceeding involves a deficiency assessment of Federal Income Tax and Excess Profits Tax for the Petitioner's calendar taxable year 1943 [R. 47]. On May 9, 1946, and pursuant to Sections 272, 600, and 729 of the *Internal Revenue Code*, the Respondent mailed to Petitioner his statutory notice of determination of deficiencies in Petitioner's income, declared value excess-profits, and excess profits taxes for the taxable year 1943 [R. 9-19]. Within the time provided in Section 272 of the

Internal Revenue Code and on July 31, 1946, the Petitioner filed a petition with the Tax Court of the United States for a redetermination of the asserted deficiencies in taxes [R. 1]. Jurisdiction was conferred on the Tax Court by Sections 1100, 1101, 272, 600, and 729 of the *Internal Revenue Code.* The decision of the Tax Court of the United States was entered on September 22, 1948 [R. 47]. Within three months and on November 30, 1948, a petition for review by your Honorable Court was filed with the Tax Court [R. 551-555], pursuant to the provisions of Section 1142 of the *Internal Revenue Code.* Jurisdiction is conferred on your Honorable Court by Section 1141 of the *Internal Revenue Code.*

Statement of the Case.

This proceeding is on petition to review a decision of the Tax Court of the United States, which determined Federal tax deficiencies against the Petitioner for its calendar taxable year 1943 in the amounts of $3,279.24 in Income Tax and $32,262.38 in Excess Profits Tax. The question for review is—Under Section 23(a)(1)(A) of the *Internal Revenue Code,* what amount of deduction is reasonably allowable to Petitioner for salary or other compensation for personal services paid or incurred in 1943 to H. L. Hoffman, the Petitioner's President and General Manager, pursuant to an employment contract executed on December 4, 1941? The entire record has been brought up for review.

On its tax return for 1943, the Petitioner claimed a deduction for $63,613.20, the amount incurred or paid by it to Mr. Hoffman pursuant to the employment contract; but the Respondent, in his statutory notice of deficiency, determined that only $25,000.00 was allowable as a deduction for tax purposes. The Petitioner petitioned the

Tax Court to reconsider the Respondent's deficiency assessment, and the Tax Court determined that $40,000.00 of the $63,613.20 compensation was an allowable deduction. In this proceeding for review of the Tax Court decision, the Petitioner still claims that it is entitled to deduct the full amount of the $63,613.20 compensation incurred or paid by it to Mr. Hoffman in 1943 pursuant to the employment contract, executed on December 4, 1941, which was in force during the taxable year at issue. Should your Honorable Court decide in favor of the Petitioner, the excess profits tax deficiency will be reduced by approximately $18,890.56, but the income tax deficiency will remain the same.

Statute, Regulations, and Rulings Involved.

The statute involved is Section 23(a)(1)(A) of the *Internal Revenue Code* which, in material part, reads as follows:

> "SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) Expenses.—
>
> (1) Trade or business expenses.—
>
> (A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *"

The regulations and rulings involved are lengthy, and for convenience are set forth in the Appendix to this brief.

Specifications of Error.

The Tax Court of the United States erred:

1. In failing to find, conclude, and hold that the $63,613.20 incurred or paid by the Petitioner to H. L. Hoffman in 1943, pursuant to an employment contract executed on December 4, 1941, was in its entirety a reasonable allowance for salary or other compensation for personal services actually rendered, within the meaning of Section 23(a)(1)(A) of the *Internal Revenue Code* [see Appendix, *infra*].

2. In finding, concluding, and holding that "Reasonable compensation for services performed by Hoffman as president and general manager of petitioner for the year 1943 was $40,000.00" [R. 38], instead of $63,613.20.

3. In failing to find, conclude, and hold that, within the meaning of Section 29.23(a)-6 of *United States Treasury Department Regulations 111* [see Appendix, *infra*], the employment contract between Petitioner and H. L. Hoffman, executed on December 4, 1941, was the result of a free bargain between the parties, made before the services were rendered, and which was not influenced by any consideration upon the part of the Petitioner other than that of securing the services of Mr. Hoffman on fair and advantageous terms.

4. In finding, concluding, and holding, with respect to the December 4, 1941, employment contract between the Petitioner and H. L. Hoffman that "there was not in this matter the free bargaining and arm's length transaction,

between a corporation and a proposed employee for services on a contingent basis, with which, under the regulation, there should not be interference" [R. 44].

5. In failing to find, conclude, and hold, within the meaning of Section 29.23(a)-6 of *United States Treasury Department Regulations 111* [see Appendix, *infra*], that in determining a reasonable allowance for contingent compensation incurred or paid in 1943 by the Petitioner to H. L. Hoffman pursuant to a contract executed on December 4, 1941, the circumstances to be considered in determining reasonableness are those which existed at December 4, 1941, the date the contingent compensation contract was executed, not those existing in 1943, the date when the deduction of the contingent compensation incurred or paid pursuant to the preexisting contract was questioned.

6. In failing to give proper effect to the finding "that petitioner's business activities were in poor condition at the time Hoffman closed the negotiations for acquiring stock and management control of it and that a great part of the success of the venture was due to his efforts" [R. 44-45].

7. In failing to find, conclude, and hold that in the case of preexisting contingent compensation contract, based on a percentage of the employer's gross sales, where the business and fiscal operations of the employer are growing in volume and overlap several calendar and accounting years, as are the facts in the case at issue, the contingent compensation incurred or paid to the employee

for any one year is, in part, necessarily compensation for services rendered by the employee in prior years as well as for the year of payment.

8. In failing to find, conclude, and hold in accordance with the unimpeached testimony of the qualified and competent expert witnesses, John H. Clippinger, James H. Tuttle, and S. W. Gilfillan that the compensation of $63,613.20 incurred or paid by Petitioner to H. L. Hoffman in 1943 was a reasonable compensation.

9. In misinterpreting and failing to give proper effect to the evidence of compensation paid for like services by like enterprises under like circumstances (Admiral Corporation, Gilfillan Bros., Inc., and commissions paid Washington representatives) in determining the reasonableness of the compensation incurred or paid by the Petitioner to H. L. Hoffman in 1943.

ARGUMENT.

I.

Summary of Argument.

The Petitioner emphasizes at the outset of its argument that it is not presenting to your Honorable Court the simple plea that, in view of the recent statutory enactment relaxing the rule on review of Tax Court decisions (*Internal Revenue Code,* Section 1141(a), as amended by Section 36, Public Law 773, 80th Congress, Second Session), your Honorable Court should scan the record and decide, as a matter of fact, that $63,612.20, rather than $40,000.00, is a reasonable allowance for compensation paid by Petitioner to its President and General Manager in 1943. On the contrary, the Petitioner's principal contention in this proceeding is that, as a matter of law, the full compensation paid by Petitioner in 1943 must be allowed as a deduction since it was paid pursuant to a preexisting contract, which contract, executed in 1941, was fair and reasonable in the light of the circumstances attending its execution; and the Treasury Department Regulation (*Reg. 111,* Sec. 29.23(a)-6(3)), which has acquired the force and effect of law by reason of the repeated reenactment of the statutory provision it interprets, specifically and definitely provides that in determining the reasonableness of a compensation allowance "The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

If, however, your Honorable Court should decide that the judicial scrutiny of the case properly covers the period subsequent to the date of execution of the employment contract, the Petitioner contends, both as a matter of

law and a matter of fact, that the record clearly shows that the compensation paid by Petitioner in 1943 to H. L. Hoffman was reasonable in relation to the services actually rendered by the man.

II.

The Tax Court Clearly Erred in Concluding That the December 4, 1941, Contingent Compensation Employment Contract Between the Petitioner and H. L. Hoffman Was Not a Fair and Advantageous Contract Resulting From a Free Bargain and an Arm's Length Transaction.

In its "Opinion," as distinguished from its formal "Findings of Fact," the Tax Court of the United States concluded that "there was not in this matter the free bargaining and arm's length transaction, between a corporation and a proposed employee for services on a contingent basis, with which, under the regulations, there should not be interference" [R. 44]. The "regulations" referred to by the Court are *United States Treasury Department Regulations 111,* Sec. 29.23(a)-6(2) [see Appendix], which read in part as follows:

> "Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid."

The Petitioner submits that the finding of the Tax Court on this basic point is a clearly erroneous conclusion in the light of the following facts of record:

(a) As of December 4, 1941, the date of the employment contract [R. 539-541] between the Petitioner and H. L. Hoffman, and the date Hoffman first became associated with the Petitioner, the Petitioner's physical plant and inventory was obsolete and in sorry shape; it had no production staff and its production activities were at a standstill; there was internal dissention in its management; it was in financial difficulties; it had a poor reputation in its industry, the radio industry; it had lost its principal sales account and had no firm future prospects; it was delinquent in its payment of salary to its then President; and it was in no position to employ Hoffman on a fixed compensation basis. [R. 22-25, 31, 33, 44, 68-71, 76-77, 80, 83, 130-132, 134-136, 164-165, 178, 193-195, 200, 213-214, 235, 246, 270-271, 275-277, 278-281, 348-349, 490, 499, 507-508, 521, 527-530.]

(b) Contingent compensation employment contracts such as that executed by Petitioner and H. L. Hoffman [R. 539-541] were well known in the radio industry generally; and were known and availed of in the then current employment histories of both the Petitioner and H. L. Hoffman. At the time Hoffman became President and General Manager of the Petitioner, the Petitioner had a contingent compensation contract with its then President, P. L. Fleming, calling for the payment of 5% on sales made by him, and it had in force two other contingent contracts with agents calling for the payment of 5% and 3% respectively on business obtained or sales made by the agents. [R. 199-200, 205-206, 80-82, 101-102, 66-67, 76-77, 83, 212-214, 275-277.]

(c) H. L. Hoffman was not in stock control nor management control of the Petitioner at the time the parties executed the contingent employment contract at issue [R. 539-541], nor was he in such control before or after that date; and the Petitioner's contract with Hoffman was agreed to and approved before its formal execution (either by written approval or by vote at the directors' meeting) by every retiring and every new stockholder, director, and officer of the Petitioner. [R. 26-31, 32-33, 76-80, 137-139, 148-149, 270-278, 346, 495, 500-502, 510-512, 517-525, 526, 531-535, 537, 539-541.]

(d) Three disinterested and qualified witnesses, who were either present or past officers or employees of competitors of the Petitioner, and one of whom (S. W. Gilfillan, the President of a competitor of the Petitioner) was originally called as the Respondent's witness, gave unimpeached testimony that the contingent compensation contract between the Petitioner and Hoffman [R. 539-541]. was a fair and reasonable contract, from the point of view of the Petitioner, in the light of the circumstances attending its execution. [R. 177-182, 193-196, 197-198, 200-204, 314-324, 275-278.]

It may be that counsel suffers from that form of myopia common to advocates for petitioners on review, but it is difficult to see any jusification in the record in this proceeding for the conclusion of the Tax Court that the employment contract between the Petitioner and Hoffman was not the result of a free bargain. Certainly the only reason stated by the Tax Court for its conclusion [R. 44] is in error and in conflict with the findings previously made by it. [R. 26-27.] That is, the Tax Court gave as the basis for its conclusion the following [R. 44]:

> "Hoffman, at the time he contracted with the petitioner corporation itself, for the contingent salary

here involved, was the owner of 110 of the 413 shares of stock, and a director, and had a contract for the purchase of the remainder of the stock. Also, he had a contract with the other individual stockholders, the Warners and Fleming (as with Schmieter from whom he had acquired the 110 shares), that he be made general manager on a basis of 3 per cent of gross sales. The contract for purchase of the Warner and Fleming stock was consummated on December 4, 1941, immediately after Hoffman's employment as general manager. All of this means to us that there was not in this matter . . . free bargaining . . ."

The Petitioner submits that there are at least two defects in the Tax Court's reasoning on this point. First: Granting that the "petitioner corporation itself" is a legal entity separate from its stockholders, directors, and officers; yet the Tax Court overlooks the fact that this legal entity, "the petitioner corporation itself," can act and *bargain* only through its stockholders, directors, and officers, and that the unanimous act and bargain of all of its stockholders, when formally carried into effect by the unanimous vote of its directors approving the bargain, and the act of the officers in signing the bargain pursuant to the directors' resolution, is necessarily the act and *bargain* of the corporation itself. Second: The stated reasoning of the Tax Court, with its implied sinister emphasis on the fact that *Hoffman* had purchased or agreed to purchase all of the Petitioner's stock, overlooks the point of its previous detailed finding [R. 26-27] that prior to the drafting, much less the execution, of any of the formal documents involved in this case, Hoffman, Davidge, and Douglas (the prospective officers, directors, and stockholders of Petitioner during the term of Hoffman's employment contract) had agreed that Hoffman

should act in acquiring the stock of Petitioner as *trustee* for himself, Davidge, and Douglas in the respective beneficial interests of 50, 25, and 25 per cent; that the three men had agreed upon the terms and procedures for acquiring stock and management control of Petitioner; and that the three men had bargained and agreed upon the terms of Hoffman's employment contract.

The Petitioner submits that, based on realities and substance, the correct analysis of this phase of the matter is as follows: The Petitioner, a corporation, is a legal entity separate from its stockholders, directors, and officers, but it necessarily must act and bargain through its stockholders, directors, and officers. By a preliminary agreement, later in fact carried into effect, Hoffman, Davidge, and Douglas were destined to be, and were in fact, the stockholders, directors, and officers of the Petitioner during the entire term of the Hoffman employment contract. [R. 26-27.] It should follow, therefore, that if the terms of Hoffman's employment contract was arrived at by a free bargain between these three men, and if that bargain was given formal expression by a resolution duly adopted by the directors of the Petitioner, and the act of its officers in executing the formal document of employment pursuant to said resolution, the contract must necessarily represent the free bargain of the Petitioner. In fact, the Hoffman employment contract was arrived at by a free bargain between Hoffman, Davidge, and Douglas. [R. 26-27, 76-80, 148-149, 270-279, 517-525.] On the advice of Mr. Davidge's attorney [R. 148-149, 270-272], the contract was approved by the outgoing stockholders and

directors of the Petitioner [R. 495, 500-502, 510-512, 531-535], and pursuant to the resolution of the directors [R. 531-535] the outgoing officers of the Petitioner executed the formal employment contract. [R. 539-541.] Further, the Hoffman contract was impliedly ratified by the new directors of Petitioner, in that the new directors, on May 14, 1942, resolved that under the contract, the fixed portion of Hoffman's compensation should be $800.00 a month. [R. 535-538.] Since the Hoffman contract was approved by every retiring or new stockholder, director, and officer of the Petitioner (Schmieter, the Warners, Fleming, M. E. Penny, Hoffman, Douglas, and Davidge) and since none of these people were acting under the compulsion of Hoffman, it must follow that the Hoffman employment contract is a product of a free bargain by the Petitioner. This conclusion is substantiated by the unimpeached testimony of officers or employees of competitors of the Petitioner (including the President of a competitor originally called as a witness by the Respondent) who testified that the Hoffman contract was very fair and reasonable one from the point of view of the Petitioner. [R. 177-182, 193-196, 200-204, 314-324.]

The Petitioner submits that the last factor mentioned is in itself a sufficient ground for the overthrow of the determination of the Tax Court on this point. That is, your Honorable Court has stated that "It is axiomatic that uncontradicted testimony must be followed," unless the witness is impeached or the testimony is improbable. (*Grace Bros., Inc. v. Commissioner of Internal Revenue* (9 Cir., Feb. 18, 1949), ... F. 2d .....) In a case involving the

reasonableness of compensation paid, the Court of Appeals for the Sixth Circuit in *Roth Office Equipment Company v. Gallagher* (6 Cir., Feb. 10, 1949), 172 F. 2d 452, restated the axiom in a manner which justifies an extended quotation, as follows:

> "No witness testified that the amounts found by the District Court as reasonable compensation in 1942 was the reasonable compensation to which the officers were entitled. The only direct evidence before the Court on the specific question of reasonableness of compensation was the testimony of Harold Hampton and Archie Shearer, both well-qualified, impartial witnesses, with many years of experience. They testified that in their opinion the compensation was reasonable . . . The credibility of these witnesses was not put in issue. The appellee offered no witness to contradict this testimony or to testify in any way that the compensation was unreasonable to any extent. On this crucial and single issue of fact in this case this unimpeached, uncontradicted testimony from well-qualified, impartial witnesses cannot be disregarded by the Court. This Court has several times stated that such testimony should be accepted by the fact-finder in a matter in which the fact-finder has no knowledge or experience upon which he could exercise an independent judgment (citing cases). As was pointed out in *T. P. Taylor & Co. v. Glenn,* 62 Fed. Supp. 495, 499, W. D. Ky., if the compensation paid is unreasonable the appellee certainly could have produced some experienced witness from the industry who could have said so, and the failure to offer such a witness on the crucial issue in the case operates very strongly against his contention. The burden of proof in cases of this kind is upon the taxpayer, but we are of the opinion that that burden has been met when the taxpayer introduces uncontradicted, unim-

> peached testimony from well-qualified, impartial witnesses sustaining its contention, unless the established facts themselves are such as to show that such testimony ought to not to be accepted."

In the instant matter, not only has Petitioner produced unimpeached evidence that the Hoffman employment contract was a fair and advantageous one to the Petitioner, and not only has the Respondent failed to produce contrary evidence, but the Respondent's own witness, Mr. Gilfillan, testified that the contract "was a good contract for the corporation" [R. 323] and was "Fair and equitable." [R. 324.] The Tax Court accepted the testimony of this witness [R. 297-344] as the basis of some of its formal findings of fact [R. 38], and it is submitted that it was required to accept his unimpeached testimony on the initial reasonableness of the Hoffman employment contract. And the same conclusion applies to the unimpeached testimony of John H. Clippinger and James M. Tuttle. Mr. Clippinger testified that the compensation stated in the Hoffman contract represented a fair and reasonable compensation [R. 182], and the Tax Court accepted other testimony of this man [R. 174-198] as the basis of some of its findings of fact. [R. 37.] Mr. Tuttle characterized the employment contract as "Most reasonable." [R. 202.]

In concluding this phase of its argument, the Petitioner submits that the record compels the conclusion that the Hoffman employment contract was a fair and advantageous contract to the Petitioner, which was arrived at as the result of a free bargain and an arm's length transaction.

III.

Section 29.23(a)-6 of United States Treasury Department Regulations 111 Has Acquired the Force and Effect of Law, and Under the Language of This Regulation the Compensation Paid by Petitioner to H. L. Hoffman in 1943 Pursuant to the Contract Executed December 4, 1941, Must Be Allowed as a Deduction.

The statutory provision involved in this proceeding, *Internal Revenue Code* Section 23(a)(1)(A) [see Appendix], authorizes the deduction of "a *reasonable* allowance for salaries or other compensation paid for services actually rendered" (italics supplied). It is an established rule that a statutory provision using such a general word as "reasonable" is peculiarly needful of an administrative regulation interpreting it. (*Helvering v. Wilshire Oil Company,* 308 U. S. 90, at 101-102, 84 L. Ed. 101, 60 S. Ct. 18); and in this instance the applicable regulation is Section 29.23(a)-6 of *United States Treasury Department Regulations 111.* This regulation has a long history in tax law, and in fact the original administrative ruling on the subject preceded the original statutory enactment by about a year, which is compelling evidence that the administrative ruling correctly reflects the Congressional intent. That is, the *Revenue Act of 1916* (Act of September 8, 1916, 39 Stat. 756, as amended) did not contain the specific provision for the deduction of a "reasonable allowance for salaries or other compensation," but simply provided for the deduction of "all the ordinary and necessary expenses paid" [see Appendix]. In order to apply this latter provision, the Treasury Department, on

April 10, 1918, issued *Treasury Decision 2696* (Vol. 20 *Treasury Decisions* (Government Printing Office, 1919), page 330) [see Appendix], which, among other things, laid down the following rules:

> "Compensation on whatever basis fixed, representing only the price paid for services pursuant to a fair bargain made in advance between the individual and the business enterprise, is deductible in determining the taxable net income of the enterprise."
>
> "In the case of compensation fixed after services are rendered and not in accordance with any contract or custom or practice amounting virtually to a contract, reasonableness is ordinarily the controlling test of deductibility."

This then was the state of the law and the administrative interpretation thereof on February 24, 1919, the date the *Revenue Act of 1918* (Act of February 24, 1919, 40 Stat. 1057) became effective; and the *Revenue Act of 1918* (Subsection 234(a)(1)) is the first act to specifically provide for a deduction of "a reasonable allowance for salaries or other compensation for personal services actually rendered." It is logical to assume that the statutory provision was and is the embodiment of the administrative ruling, for the statutory provision and the administrative ruling have had the following histories—

Statutory history: The quoted provision of Subsection 234(a)(1) of the *Revenue Act of 1918* was reenacted as Subsection 234(a)(1) of the *Revenue Acts of 1921, 1924, and 1926;* as Subsection 23(a) of the *Revenue Acts of 1928, 1932, 1934, and 1936;* as Subsection 23(a)(1) of the *Revenue Act of 1938;* and as Subsection 23(a)(1)(A) of the *Internal Revenue Code.*

Administrative ruling history: The provisions of *Treasury Decision 2696* [see Appendix], or provisions essentially and substantially similar to it, have been in force as Article 105 of *Regulations 45* (1918-19-20), Art. 105, *Reg. 62* (1921-22-23), Art. 106, *Reg. 65* (1924), Art. 106, *Reg. 69* (1926), Art. 126, *Reg. 74* (1928), Art. 126, *Reg. 77* (1932), Art. 23(a)-6, *Reg. 86* (1934), Art. 23(a)-6, *Reg. 101* (1938), Sec. 19.23(a)-6, *Reg. 103* (1940), and Sec. 29.23(a)-6, *Reg. 111* (1941 to date).

The foregoing histories, including the fact that the administrative interpretation antedated the specific statutory provision, emphasize the logic and reason for the application to the question at issue of the established principle that a consistent and longstanding administrative interpretation of a statutory provision, reenacted without change, must be presumed to conform to the legislative intent, and must be given the force and effect of law. *Crane v. Commissioner of Internal Revenue,* 331 U. S. 1, 91 L. Ed. 931, 67 S. Ct. 1047; *Helvering v. R. J. Reynolds Tobacco Co.,* 306 U. S. 110, 83 L. Ed. 536, 59 S. Ct. 423; *White, et al., Executors v. United States,* 305 U. S. 281, 83 L. Ed. 172, 59 S. Ct. 179; *Helvering v. Winmill,* 305 U. S. 79, 83 L. Ed. 52, 59 S. Ct. 45; *United States v. Dakota-Montana Oil Company,* 288 U. S. 459, 77 L. Ed. 893, 53 S. Ct. 435; *Commissioner of Internal Revenue v. West Production Co.* (9 Cir.), 121 F. 2d 9.

The Petitioner, therefore, respectfully submits the following as the controlling principle in the decision of the question at issue:

Sec. 29.23(a)-6 of *Regulations 111* has the force and effect of law. Said regulation unequivocally states the following (italics supplied):

> "(3) In any event the allowance for the compensation paid may not exceed what is reasonable un-

> der all the circumstances. . . . *The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.*"

As the Petitioner has shown in the preceding division of this brief, the record in this proceeding clearly warrants the conclusion that the Hoffman employment contract was the result of a free bargain, and was fair and reasonable in the light of the circumstances attending its execution. It follows, therefore, that the compensation paid by Petitioner to Hoffman in 1943 pursuant to the December 4, 1941, employment contract must be allowed as a deduction since the controlling circumstances governing reasonableness are "those existing at the date when the contract for services was made."

It is apparent from the Tax Court opinion that a prime source of the Tax Court's error in this case lies in its studied disregard of the underlined language in the regulation quoted above. For example, the Tax Court opinion [R. 42] states as follows:

> "Section 29.23(a)-6(3) provides that 'In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances.' The remaining portion of the section does not alter the conclusion that the amount paid must be reasonable."

True the remaining portion of the regulation does not alter the conclusion that the amount paid must be reasonable, but said remaining portion states unequivocally that the circumstances to be considered in determining reasonableness are "those existing at the date when the contract for services was made"; yet the Tax Court

ignored this important provision. Again, in discussing the case of *Austin et al. v. United States* (5 Cir.), 28 F. 2d 677, the Tax Court [R. 42-43] lightly dismissed the case as "stating generally that it is immaterial that the actual working out of a contract may prove greater than the amount ordinarily paid"; whereas in fact the *Austin* case specifically decided (28 F. 2d at 678) that contingent compensation paid pursuant to a contract which "Under normal conditions, doubtless . . . would have been unreasonable," must be allowed as a deduction because "The reasonableness of the contract is to be viewed in the light of the circumstances that existed when it was made." It is difficult to understand why the Tax Court ignored this language of the *Austin* case, for it is not a dictum but is the basis of decision in that case, and it has an obvious bearing on the present inquiry. In fact, the attitude of the Tax Court on this point is not a little disquieting when contrasted with the opinion of the same Tax Court Judge dealing with the same issue in a case heard by the Judge on the same calendar as that in which this Proceeding was heard. That is, in the case of *California Vegetable Concentrates, Inc.* (June 23, 1948), 10 T. C. 1158 (No. 150), one issue was the reasonableness of deductions paid officer-stockholders in the form of fixed salaries plus contingent compensation of from 25 to 35 per cent of the net profits. Judge Disney upheld the deductions, and in the course of his opinion he stated the following:

> "The Treasury Regulations approve broadly the method employed by petitioner to fix the amount of the compensation in question (quoting subdivisions (2) and (3) of *Reg. 111,* Sec. 29.23(a)-6)."
>
> "The arrangements disclose a fixed policy of petitioner to pay its key officers compensation based, in

part, upon net profits. It has been held that such a policy 'is based primarily upon sound business principles', *Gray & Co. v. United States,* 35 F. (2d) 968. In *Austin v. United States,* 28 F. (2d) 677, the Court said that 'The reasonableness of the contract is to be viewed in the light of the circumstances that existed when it was made' and 'It is immaterial that in the actual working out of the contract contingent compensation may prove to be greater than the amount which ordinarily would be paid.' "

Are we to understand then that on June 23, 1948, the cited regulation, the *Austin* case, and the *Gray & Co.* case are to be regarded as compelling precedents in the decision of a reasonable compensation issue (10 T. C. 1158, No. 150), whereas six days later the same precedents can be lightly dismissed by the same judge as inapplicable to a decision on the same issue? [R. 42-43.]

The *Austin* case (28 F. 2d 677) is material to the present inquiry for additional reasons. The case was decided under the *Revenue Act of 1918* (40 Stat. 1077) which, as previously developed herein, was the first revenue act to specifically provide for the deduction of a "reasonable allowance for salaries or other compensation," and the court cited and relied upon the administrative regulation (*Reg. 65,* Art. 106, a predecessor of *Reg. 111,* Sec. 29.23(a)-6) in deciding the case. Further, the circumstances which impressed the court as indicating the initial and controlling reasonableness of the contingent compensation contract there involved were that (28 F. 2d at 678) "When the contract for salaries was entered into, the corporation was financially unable to continue in business. What it did was practically to give up its business because of its inability to carry it on." It is submitted that these circumstances find a close parallel in the record in

this matter for, as the Petitioner has developed in the preceding division of this brief, at the time the Hoffman contingent compensation contract was executed on December 4, 1941, the Petitioner's physical plant and inventory were obsolete and in sorry shape; it had no production staff and its production activities were at a standstill; there was internal dissention in its management; it was in financial difficulties; it had a poor reputation in the radio industry; it had lost its principal sales account and had no firm future prospects; it was delinquent in its payment of salary to its then president; and it was in no position to employ Hoffman on a fixed compensation basis. [R. 22-25, 31, 33, 44, 68-71, 76-77, 80, 83, 130-132, 134-136, 164-165, 178, 193-195, 200, 213-214, 235, 246, 270-271, 275-277, 278-281, 348-349, 490, 499, 507-508, 521, 527-530.] The Tax Court admitted [R. 44-45] that "petitioner's business activities were in poor condition at the time Hoffman closed the negotiations for acquiring stock and management control of it and a great part of the success of the venture was due to his efforts"; yet it failed to give effect to this circumstance because of its obvious disregard, in this case, of the principle that the reasonableness of a compensation payment made pursuant to a pre-existing contract is to be judged in the light of the circumstances existing at the time the contract was entered into.

Your Honorable Court, in the case of *Harvey v. Commissioner of Internal Revenue* (9 Cir.), 171 F. 2d 952, has indicated adherence to the principle here contended for by the Petitioner. The *Harvey* case, among other points, involved the deductibility of a contingent fee paid by a father to his son, an attorney. There the taxpayer, relying on an alleged contract with his son, failed to introduce evidence of the value of the son's actual services, and

your Honorable Court, upon sustaining the conclusion of the Tax Court that the contract was not a bona fide one, remanded the case to permit the introduction of evidence of the value of the services rendered, and stated the following (171 F. 2d at 955; italics supplied):

> "The Tax Court held the contract ineffective insofar as the tax situation was concerned. *The petitioner, relying on the contract, was not called upon to produce evidence of the reasonable value of the services rendered.* The alleged contract being held ineffective he should have the opportunity to submit such evidence, and the case should be reopened for that purpose."

In other words, as the Petitioner understands your ruling, if a contract for services is a reasonable and valid one in the light of the circumstances attending its execution, the taxpayer's burden of going forward, and the judicial scrutiny, stops at that point; and only in the event that the preexisting contract is found wanting need the taxpayer and the court inquire into the events which subsequently occur in the working out of the contract. In view of this principle, which is the same as that set forth in the controlling regulation, quoted above, and in the *Austin* case (28 F. 2d 677), the Petitioner respectfully submits that it is entitled to judgment in this proceeding, since the record clearly shows that the Hoffman contingent compensation contract was a fair and reasonable one in the light of the circumstances existing on December 4, 1941, the date of its execution.

IV.

The Compensation Paid by Petitioner in 1943 to H. L. Hoffman, Its President and General Manager, Was Reasonable in Relation to the Services Actually Rendered by Hoffman.

While the Petitioner respectfully submits that the judicial scrutiny of the compensation deduction at issue should cease upon being satisfied that the December 4, 1941, contingent compensation contract between Petitioner and H. L. Hoffman was the result of a free bargain, and was a reasonable contract in the light of the circumstances attending its execution; yet, if further review is considered necessary, the record in this proceeding clearly demonstrates that the compensation paid for the year at issue was reasonable in relation to the services rendered by Hoffman.

The salient factor to consider is that under the presidency and general managership of Hoffman, the Petitioner progressed in the short space of the years 1942 and 1943 from an insolvent company, with inadequate and obsolete equipment, no production staff, and a bad reputation in the industry [R. 22-25, 31, 33, 44, 68-71, 76-77, 80, 83, 130-132, 134-136, 164-165, 178, 193-195, 200, 213-214, 235, 246, 270-271, 275-277, 278-281, 348-349, 490, 499, 507-508, 521, 527-530] to a prosperous going concern with modern equipment and a staff of 297 employees, successfully engaged in the production of the most exacting type of precision instruments, and it had become one of the key prime war contractors for the Navy, and it was the only West Coast contractor in the electronics field to be recommended for the Army-Navy E award. [R. 23-25, 33-34, 35-36, 84-94, 346-390, 95-100, 391, 392-393, 100-105, 106-108, 153-163, 167-168, 170-

172, 173-174, 184-185, 202-203, 215-227, 229-236, 257-259, 264-265, 485 (Section XVIII), 549.] It is material to note that the Tax Court found [R. 45] "that a great part of the success of the venture was due to his (Hoffman's) efforts," and counsel for the Respondent conceded that Hoffman was "undoubtedly one of the main motivating factors in the organization." [R. 55.] It is submitted that since admittedly a great part of Petitioner's success was due to Hoffman's efforts, it was not unreasonable to compensate Hoffman in relation to that success, pursuant to a preexisting and binding contingent compensation contract. As the court stated in the case of *William S. Gray & Co. v. United States* (Ct. Cls.), 35 F. 2d 968 at 974—

> "Every business is largely dependent upon the capacity, resourcefulness, and assiduity which its executive officers give to it . . .,"

and the court sagely pointed out that—

> "The policy of agreeing to pay a percentage of the earnings before they are earned, or even a sum in the nature of a bonus after they are earned, is based primarily upon sound business principles. It stimulates the activity, diligence, and ambition of the employees in the case of a percentage of the profits, and in both the case of a percentage and of a bonus it enables the corporation to justly compensate its employees without beforehand incurring the obligation. . . . If the profits were small, the sum realized from the percentage was small, and if the profits were large, the sum so realized was larger, depending in each year upon the loyalty, vigilance, and intelligent effort, and the stimulated ambition of each of the parties. . . ."

Further, the Respondent's own *Regulations 111,* Section 29.23(a)-6(2) (which, as previously developed herein, has acquired the force and effect of law) states that—

> "Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration upon the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid."

That is, the regulation sets up a general rule that contingent compensation may well exceed the amount which might be paid as fixed flat rate compensation and still be classed as reasonable.

During the year at issue, 1943, the Petitioner had only three active executive officers, including H. L. Hoffman. [R. 485, Sec. XVI, 545, 34.] Hoffman was the President and General Manager of the Petitioner; he was its only salesman and business solicitor, and he obtained war contract orders in the amount of $4,382,050.13 in 1942 and $888,244.81 in 1943; he was in charge of personnel; he handled advertising and public relations work; he was coordinator of production; he performed the work usually performed by a Washington representative; he was instrumental in organizing, and was the first president of, the West Coast Electronics Manufacturers Association, which organization contributed substantially in helping smaller companies, including Petitioner, to secure war contracts; he negotiated the bank financing necessary to obtain working capital for the Petitioner, and, together

with Mr. Davidge and Mr. Douglas, he personally guaranteed the bank loans; he, together with Mr. Davidge and Mr. Douglas, advanced funds to the Petitioner to enable it to make the down payment on its major asset, a plant needed to handle its Navy frequency meter contract; he participated in making technical decisions on the feasibility or non-feasibility of submitting bids on various types of contracts; and he worked a fourteen to sixteen hour day. [R. 34, 35-36, 80, 84-92, 100-101, 106-108, 157-158, 161-162, 264-265, 346-393.] In the face of this record, it shouldn't be necessary to state that Hoffman worked hard and rendered valuable services during 1943, yet the Tax Court apparently reached the contrary conclusion for it stated the following [R. 45]:

> "There is no indication that his services that year (1943) were of any greater value than the year before when he received a substantially smaller salary and bonus. In fact, the contrary may be true since he obtained war contract orders in the amount of $4,382,050.13 in 1942 and in the amount of only $888,244.81 in 1943."

The errors in the Tax Court's reasoning on this point are glaring. In the first place, business solicitation was only one of Hoffman's manifold duties, see above. Secondly, it should have been clear to the Tax Court that orders, once obtained, have to be translated into production and delivery, and since the Petitioner's net sales in 1942 and 1943 were $351,950.62 and $1,787,850.14 [R. 23] it is obvious that it was working on the 1942 orders in 1943 and later years. In this connection, the Tax Court found as a fact that "Production and delivery under the orders obtained in any one year was not necessarily limited to the year in which the order was obtained" [R. 35-36],

yet it failed to give effect to this finding in evaluating Hoffman's services in 1943. The record shows that Petitioner's 1943 sales volume increased 689% over 1942, and its personnel expanded 177% [R. 373, 377-378], and since Hoffman was coordinator of production, in charge of personnel, etc., it should have been clear to the Tax Court that his duties necessarily increased in 1943. Other Tax Court judges presume an increase in duties and responsibilities from an expansion of production; for example, see the opinion of Judge Le Mire in *Chandler Products Corporation,* Tax Court Memorandum Decision entered September 23, 1948, Docket No. 13990, Commerce Clearing House Tax Court Reporter Decision 16,596(M):

> "While its large increase in business in 1941 and 1942 was due to the war, it undoubtedly resulted in an increase in the duties and responsibilities of the officers."

It is also interesting to note the comment of Judge Disney, the Judge below, in the case of *California Vegetable Concentrates, Inc.,* 10 T. C. 1158, No. 150, to which detailed reference has been made in the preceding division of this brief. In the *California Vegetable* case Judge Disney reasoned that "The large profits in the taxable years were made possible to a large extent by the effort expended by Sims and Pordieck in prior and less profitable years"; yet in the case of this Petitioner the same Judge ignored this factor. As a final comment on this phase of the Tax Court's error, it is clear that since Hoffman's contingent compensation was geared to sales and not to orders, and since the 1943 sales were greater than the 1942 sales [R. 23], the necessarily smaller compensation paid to Hoffman in 1942 is not, as the Tax Court appears to have reasoned, a precedent for restricting the amount of Hoffman's 1943 compensation.

The Petitioner submits that the action of the war contracts renegotiation authorities in accepting as reasonable the compensation paid by Petitioner to Hoffman in 1943 [R. 104-105] is material to the issue under review, since it represents the considered judgment of an arm of the Federal government equal in importance to the Respondent in a matter that was of special concern to the renegotiators. The *Renegotiation Act of 1943* (Act of April 28, 1942, Section 403(a), Sixth Supplemental National Defense Appropriation Act, 1942, Public Law No. 528, 77th Congress, 2d. Session, as amended by Act of February 25, 1944, Section 701(b) of Revenue Act of 1943, Public Law No. 235, 78th Congress, 2d. Session) provided in part as follows:

> "In determining excessive profits there shall be taken into consideration the following factors: . . . (ii) reasonableness of costs and profits . . ."
>
> "Irrespective of the method employed or prescribed for determining such costs, no item of cost shall be charged to any contract . . . or used in any manner for the purpose of determining such cost, to the extent that in the opinion of the Board . . . such item is unreasonable. . . . Nothwithstanding any other provisions of this section, all items estimated to be allowed as deductions and exclusions under Chapters 1 and 2E of the Internal Revenue Code (excluding taxes measured by income) shall . . . be allowed as items of cost . . ."

Chapter 1 of the *Internal Revenue Code,* referred to in the last quotation, covers Section 23(a)(1)(A), the statutory provision involved in this proceeding; hence, the applicability of this provision to the 1943 Hoffman compensation was necessarily considered by the renegotiation board; and this is made clear by the Renegotiation Regulations, pro-

mulgated on March 24, 1944, by the War Contracts Price Adjustment Board. *Renegotiation Regulations* Section 381.4(3) provides in part as follows:

> "The Act requires the War Contracts Board to allow as items of cost . . . all items estimated to be allowable as deductions and exclusions under Chapters 1 and 2E of the Internal Revenue Code. . . . However, the Act does not require the allowance of items as costs merely because they have been or are expected to be allowed for tax purposes by particular revenue agents or other representatives of the Bureau of Internal Revenue. Occasionally cases may be encountered where revenue agents have allowed salaries or other items as deductions for tax purposes which the renegotiating agency concludes are not properly allowable under the Internal Revenue Code or are properly allowable in a different amount. In such cases the action of the revenue agents need not be regarded as conclusive. The renegotiating agency may and should exercise independent judgment as to whether and to what extent the items are allowable as deductions or exclusions under the Internal Revenue Code. Such judgment should be based upon an estimate of what the courts would do if the deductibility or excludibility of the item were the subject of litigation."

The Petitioner contends that the act of the war contract renegotiating board in accepting the 1943 Hoffman compensation as a proper element of cost [R. 104-105] is strong and impartial evidence of the reasonableness of that compensation under the provision of the *Internal Revenue Code* involved herein. Further impartial evidence along this line is the fact that the California Bank and the Federal Reserve Bank of San Francisco placed no

restriction on the payment of the Hoffman contingent compensation in the Loan Agreement executed July 10, 1943, and the Guarantee Agreement executed September 8, 1943. [R. 394-413.] Paragraph 6 of the Loan Agreement [R. 405-407] provides in part as follows:

> "6. While any of the revolving credit granted to the Borrower under this Agreement is in use or available to it and so long as any of the notes evidencing loans under this Agreement are unpaid the Borrower agrees that:
>
> (a) Without the prior written consent of the Bank and the prior written consent of the Federal Reserve Bank of San Francisco . . . the Borrower will not . . . (iv) Declare or pay any cash dividends upon its capital stock . . .; . . . (viii) Permit Borrower's officers and/or directors to withdraw more than the aggregate sum of $1,500.00 cash per calendar month as salaries, or to make any cash payments to Borrower's officers or directors as fees, bonuses or otherwise *except pursuant to agreements which were already in effect on January 1, 1943;*" (italics supplied).

It is logical to assume that if either the lendor bank or the guarantor Federal Reserve Bank had believed that the Hoffman contingent compensation contract for 1943 was unreasonable, a definite restriction would have been placed on payments by Petitioner to Hoffman; but in fact both institutions accepted the contract as a reasonable one.

Other evidence that the 1943 Hoffman compensation was reasonable appears in the record. Hoffman's contingent compensation was at the rate of 3% of sales. He was the Petitioner's only salesman and business solicitor

[R. 35] in addition to his other onerous duties as President and General Manager of Petitioner (see above); and it was not uncommon in the year at issue to pay business solicitors commissions of 3% and 5% on business obtained. [R. 101-102, 182-183, 195.] Further, the Respondent put on the testimony of S. W. Gilfillan [R. 297-342] for the stated purpose of setting up a comparative standard of reasonableness [R. 320-321]; yet judged by the Respondent's own comparative (Gilfillan Bros., Inc.), the Petitioner makes the more favorable showing, as follows:

Ratio of General and Administrative Expenses to Net Sales

	Gilfillan Bros., Inc.	Petitioner
Before renegotiation	8.47%	6.36%
After renegotiation	8.73%	6.54%

[R. 479, 358, 530, 23, 38.]

That is, even though the net sales of Gilfillan Bros., Inc. were approximately two times those of Petitioner, and even though it generally follows that the ratio of general and administrative expenses decreases in amount as sales increase, yet the Petitioner's general and administrative expenses (including the compensation of H. L. Hoffman) were considerably a lesser percentage of its smaller net sales than was true in the case of the Respondent's comparative. This is convincing proof that the compensation paid by Petitioner to Hoffman was reasonable, in that it did not inflate general and administrative expenses in relation to sales. Further proof of the reasonableness of the Petitioner's compensation payments is found in the fact that Petitioner netted a greater percentage of profits (profits *after salaries* and renegotiation, and before Fed-

eral taxes) than did the Respondent's comparative. That is, the Petitioner's Net Profit Before Federal Taxes of $171,432.94 represents a net profit of 9.59% of its net sales, whereas the Gilfillan Bros., Inc.'s Net Profit Before Federal Taxes of $306,949.64 represents a net profit of only 8.78% of its net sales. [R. 23, 38, 479-480, 530.] Certainly if the compensation paid by Petitioner to Hoffman had been unreasonably inflated, it would not have netted a greater percentage of profit than the profit of the Respondent's comparative.

It is, perhaps, stressing the obvious to point out that in the proceeding at issue there was no element of "milking" the corporation to pay the salary of a favored officer-stockholder. Even after the payment of salaries, the Petitioner realized a net profit before taxes of $171,432.94 which represented a return of over 100% on its capital accounts, the latter consisting of Preferred Stock, $72,500.00, Common Stock, $41,300.00, and Paid-in Surplus, $10,373.71, or a total capital of $124,173.71. [R. 528.] Further, even after the payment of salaries (and even if the Petitioner is wholly successful in this proceeding) its taxable income will be such that will pay approximately $156,215.74 in Federal income and excess profits taxes. [R. 9-19.] The Petitioner submits, and the Tax Court so found [R. 45] "that a great part of the success of the venture was due to his (Hoffman's) efforts"; and that the Petitioner's compensation payments to Hoffman were not only reasonable but are proof of the fact (stated in the case of *William S. Gray & Co. v. United States* (Ct. Cls.), 35 F. 2d 968 at 974) that "The policy of agreeing to pay a percentage of the earnings before they are earned . . . is based primarily upon sound business principles. It stimulates the activity, diligence, and ambition of the employees . . . and . . . it

enables the corporation to justly compensate its employees without beforehand incurring the obligation."

The Petitioner may be in error on the point, but it cannot help but feel that its case was ill-received before the Tax Court because 99.96% of its 1943 sales related to war orders. This feeling doubtless finds its origin in the contrast between the Tax Court decision in this case, and the decision in the case of *California Vegetable Concentrates, Inc.,* 10 T. C. 1158, No. 150, to which reference has been made above in two divisions of this brief, and in the remark of the Court [R. 45] that "In 1943 petitioner did an unusually large amount of business, attributable in the main . . . to war conditions of the year." The Petitioner might feel selfconscious about this point were it not for the fact that war conditions brought an abrupt halt to its budding peacetime business [R. 22, 481-482, Sec. III, 486-487]; and for the fact that it made a substantial and valuable contribution to the war efforts [R. 34, 36, 53, 184-185, 202-203]; and for the further fact that the war contracts renegotiation board approved its compensation arrangements; see above. That is, the peacetime operations of the Petitioner were devoted to the manufacture of home radios. After H. L. Hoffman took over the presidency and general managership of the Petitioner, and starting from scratch on January 1, 1942, it manufactured and sold, in less than a year, some $122,799.03 in commercial radios [R. 488], in contrast to sales of only $29,763.82 for the year prior to Hoffman's employment. [R. 23.] The peacetime business of Petitioner was early in 1942 brought to a close by a general order of the War Production Board, issued March 7, 1942, and effective April 23, 1942, which restricted and finally prohibited the commercial manufacture of radio receivers. [R. 22, 486-487.] Thus the Petitioner was faced

with a Hobson's choice of oblivion or going into war production. War orders were not easily obtainable in the electronics field because (1) the Petitioner, located in Los Angeles, California, was in a "number one critical labor area"; that is, an area classified as one in which a critical labor shortage existed and in which war orders were to be restricted to airplane manufacture and shipbuilding and to the exclusion of other war orders [R. 34, 91, 106-107]; (2) Army and Navy procurement offices, located in the East, regarded the West Coast as an invasion zone [R. 91]; and (3) Army and Navy procurement officers had to be convinced that West Coast industry could manufacture and supply component parts. [R. 90-91, 106-107.] In spite of these obstacles, Hoffman was successful in obtaining substantial war orders for the Petitioner. [R. 34, 35.] The type of war contracts obtained and performed by the Petitioner were not those involving simple, mass-scale assembly work, but, on the contrary, as the Tax Court found [R. 36], they required the exercise of managerial, engineering, and mechanical skill and inventiveness in design, production, procedures, tooling, testing equipment, and the efficient use of, or substitution for, materials which were critically short in supply; and many of the orders were not of the type solicited by comparable companies, or they were orders in the performance of which other companies had failed. [R. 36, 184.] The Petitioner successfully and efficiently performed its war effort, and it was the only West Coast company in the electronics field to receive the Army-Navy E award from the Navy. [R. 34, 102.] James M. Tuttle, a witness at the hearing, who had been a Navy lieutenant and the assistant head of the production department of the electronics division of the Bureau of Ships, Navy Department, and who stated that he learned at first hand the capabilities

and facilities of all radio manufacturers in the United States, testified that the Petitioner earned a reputation with the Navy Department to such an extent that it became a key prime contractor for the Navy. [R. 202-203.]

The Petitioner is proud of its war record, and it submits that that record should not be classed as a detrimental factor in this proceeding. As the court stated in the case of *Roth Office Equipment Company v. Gallagher* (6 Cir., Feb. 10, 1949), 172 F. 2d 456, "While economic conditions brought on by the war is a factor to be considered in these cases, the Tax Court has held several times that this alone does not establish unreasonableness where war business has resulted in increased work and responsibility (citing cases)." See also *Chandler Products Corporation,* Tax Court Memorandum Decision, Docket No. 13990, September 23, 1948, Commerce Clearing House Tax Court Reporter, Decision 16,596M; *Elbert Steel Corporation,* Tax Court Memorandum Decision, Docket No. 4401, May 21, 1945, Commerce Clearing House Tax Court Reporter, Decision 14,576(M). The fact that war conditions resulted in increased work and responsibility for the Petitioner and Hoffman is apparent from the record, and has been developed at length hereinabove; and in the light of this fact, the *Roth* case, *supra,* establishes the rule that economic conditions brought on by the war are not a factor in establishing unreasonableness of compensation paid in the form of bonuses, much less compensation paid pursuant to a preexisting, binding contingent compensation contract.

Conclusion.

The Petitioner contends that the Tax Court clearly erred in not allowing the Petitioner a deduction for the entire $63,613.20 compensation paid by it to H. L. Hoffman in 1943, and the decision should be reversed on this point.

Los Angeles, California, April 11, 1949.

Respectfully submitted,

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APPENDIX.

Statutes.

Internal Revenue Code, Section 23(a)(1)(A).

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

Revenue Act of 1916 (Act of Sept. 8, 1916, 39 Stat. 756), as Amended, Sec. 12(a).

Sec. 12(a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, * * *

UNITED STATES TREASURY DEPARTMENT REGULATIONS.

REGULATIONS 111, SEC. 29.23(a)-6.

Sec. 29.23(a)-6. Compensation For Personal Services. —Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries

of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Treasury Decisions.

Treasury Decision 2696, Vol. 20, Treasury Decisions (Government Printing Office, 1919), Page 330.

Treasury Department
Office of Commissioner of Internal Revenue
Washington, D. C.

To collectors of internal revenue and others concerned:

Section 5(a) of the income-tax act of September 8, 1916, as amended, provides, as to the income of individuals and partnerships, that for the purpose of the tax there shall be allowed as deductions, among others, "the necessary expenses actually paid in carrying on any business or trade," and section 12(a) provides that the net income of a corporation shall be ascertained by deducting from the gross amount of its income received within the year, among other things, "all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties."

Payments for services by business enterprises (including individuals in business, partnerships, and corporations) may, of course, be deducted under this general language. The Government, entitled to taxes based on the net income of each enterprise, is interested and authorized, however, to see that each specific expenditure sought to be deducted is in itself "necessary." The question is by what examination and what test this shall be determined. The subject is not dealt with in any general way in the income-tax regulations, although article 138 bears on special payments to employees of corporations.

The test of deductibility in the case of compensation payments is whether they are in fact payments purely for

services or include some other element. But in the case of any compensation, however determined, which exceeds amounts ordinarily paid for like services in like enterprises under like circumstances, the burden is upon the enterprise to show that the amount paid was solely the purchase price of services. This test and its practical application may be further stated and illustrated as follows:

1. Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible.

(a) An ostensible salary may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few stockholders, practically all of whom draw salaries. If in such a case the salaries are based upon or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries, if in excess of those ordinarily paid for similar services, are not paid wholly for services rendered, but in part as a distribution of earnings upon the stock.

(b) An ostensible salary paid by a corporation may be in part a waste or appropriation of assets of the corporation. This may occur where salaried employees are in control of the corporation through holding directly or indirectly a majority of its stock or, in the case of a large corporation with many stockholders, owning a substantial minority of its stock, and the tendency of the officers unduly to inflate their salaries must be taken into account. If a compensation contract with the majority stockholder or stockholders is approved by all the stockholders, as well as by the directors, it might, however, be dealt with like any other contract.

(c) An ostensible salary may be in part payment for property. * * *

2. The form or method of fixing compensation is not decisive as to deductibility.

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the enterprise and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

3. As to compensation determined after services have been rendered, reasonableness is ordinarily the controlling test of deductibility.

In certain instances apparently of this sort it may be shown that the compensation is fixed according to a custom or practice having virtually the force of a contract. Where, however, such is not the case and it is for the management to fix compensation such as is deemed fair, it is just to assume that true compensation is only such amount as would ordinarily be paid in like circumstances by other similar enterprises.

* * * * * * * * *

The foregoing rules naturally do not permit a ready determination of every question arising as to compensation payments, but applied in the light of full knowledge of the facts in the particular case they do, however, indicate a basis of solution. They may be summed up as follows:

Compensation on whatever basis fixed, representing only the price paid for services pursuant to a fair bargain made in advance between the individual and the business enterprise, is deductible in determining the taxable net income of the enterprise. Payments nominally as compensation for services, which in fact include amounts paid as dividends, waste of corporate assets, payments for property or for anything other than services, are deductible only to an amount not in excess of compensation for like services in similar enterprises.

Compensation greater than that ordinarily paid for like services in similar enterprises must be shown to represent payment for services only. In the case of compensation fixed after services are rendered and not in accordance with any contract or any custom or practice amounting virtually to a contract, reasonableness is ordinarily the controlling test of deductibility.

DANIEL C. ROPER,
Commissioner of Internal Revenue.

Approved April 10, 1918:

R. C. LEFFINGWELL,
Acting Secretary of the Treasury.